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AUTHORITIES CITED—

CASES:

STATUTES:

IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 682

WARREN J. HARANG,
Petitioner

versus

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

REPLY BRIEF ON BEHALF OF PETITIONER.

May It Please the Court:

In the brief of the Government opposing the granting of a writ of certiorari, the startling statement is made that the United States Circuit Court of Appeals decided only a question of Louisiana law, and, therefore, no federal question was involved. It is said by Government counsel:

> "To the extent that the petition for a writ of certiorari (Pet. 4-10; Br. 4-22) has been framed

> on the assumption that there is a fundamental conflict between the decision below and the cases which uniformly hold that oil royalties are taxable as ordinary income rather than as proceeds from the sale of a capital asset (*Burnet v. Harmel*, 287 U.S. 103), the contention is without foundation".

The petition for a writ of certiorari was not framed to erroneously present a conflict of decision between the decision in *Commissioner vs. Gray*, 159 Fed. (2) 834 and the case at bar and other cases dealing with royalties but the issue framed itself. It is inescapable that the Court of Appeals was dealing with a question of income under the congressional statutes. The ultimate question decided was not as to where the income came to rest, but what was the nature of the income. It was necessary to decide whether royalties were ordinary income to determine whether the Commissioner was right in assessing the deficiency. Congress has in unqualified terms said that royalties, like rents, are ordinary income. The Court of Appeals, in defiance of the congressional command, has said that royalties are not ordinary income, but that royalties are the price paid to the taxpayer for the alienation of real estate. That was the ultimate issue in the case, and while the Court of Appeals discussed at great length the difference between "fruits" and "profits" to determine where the royalties finally came to rest, it nevertheless said unequivocally that royalties are not ordinary income as declared by Congress, but that royalties are the price for the partial alienation of land. It held that only the "fruits" of the separate estate of the husband fell into the community and royalties are not fruits. To determine whether or not these royalties fell into the community, or fell into the separate estate of the husband, the Court of Appeals was called upon to determine the nature of these royal-

ties, and, contrary to the congressional choice, said that these royalties were not income within the federal taxing statutes, but were the purchase price for the sale of land belonging to the husband, and, consequently, being the consideration for the partial alienation of his separate estate belonged to his separate estate, and did not belong to the community.

In the *Gray* case, the Commissioner contended that under the law of Louisiana royalties were not income like rent, and, consequently, not being income from the separate estate of the husband, did not fall into the community. The contention made in the *Gray* case was that royalties, unlike rents, were the consideration for the alienation of the separate property of Gray, and, being a consideration for the sale of his property, were not income, and, consequently, belonged to him and not to the community. This contention was rejected by the Tax Court, but upheld by the Court of Appeals, with the resulting anomaly that the Commissioner treated these royalties as a consideration for the sale of property, but yet compelled the taxpayer to pay a tax as if these royalties were ordinary income. The inconsistency of his position is that for the purpose of levying the tax, the royalties were ordinary income, but for the purpose of determining by whom the tax was to be paid, these royalties were the purchase price of land.

The involved reasoning of the Court of Appeals regarding "fruits" and "profits" is not greatly material here, but the historical background might be interesting. In 1811, Congress passed a statute admitting Louisiana to the Union. A condition of the admission was that the laws of Louisiana, theretofore passed in French, should be enacted in English. A Constitutional Convention was

held in 1811 and in 1812, the Constitution was adopted which, by Article 6, § 16 provided that the laws should be passed in English. Because of the large number of French speaking people, the code adopted in 1825 was adopted in English, but promulgated in both English and French. The English publication said that all of the "profits" from the separate property of the husband should fall into the community. (Article 2402 R. C. C.) The French version said that the "fruits" of the separate property of the husband shall fall into the community. The Louisiana Legal Archives, a compendium of the Codes of Louisiana, has a note that the word "fruits" in Article 2371 of the Code of 1825, which corresponds to the present Article 2402 of the Revised Civil Code, had been erroneously translated and that "fruits" had been translated into "profits". Although the revision of the Code of 1870 was enacted and promulgated in English, the Court of Appeals adopted the note in the Louisiana Legal Archives and held that only the "fruits" of the separate property of the husband fell into the community, and that royalties were not fruits within the meaning of the law.

This statement was made in spite of the fact that this court, in *Viterbo vs. Friedlander*, 120 U.S. 723, had distinctly held that the English Code of 1825 was the law, and not the French promulgation. The Court of Appeals further overlooked the compelling argument that regardless of what had gone before, that in 1902, Article 2402 of the Code had been amended by Act 68 of the General Assembly of 1902, and that the word "profits", and not the word "fruits" had been the chosen term. The Court then proceeded to hold that royalties were not fruits as contemplated by other parts of the Civil Code and that, consequently, royalties were not

income, but were a consideration for the partial alienation of the separate property of the husband.

The Court then affirmed the decision of *Commissioner vs. Gray, supra*, wherein the court said:

> "As the execution by a fee owner of an oil and gas lease is a dismemberment of property amounting to a partial alienation and the bonus is the cash consideration paid, therefore, it follows that the bonus paid the taxpayer for an oil and gas lease falls into his separate estate".

If this is not a decision contrary to the jurisprudence of this court and of the various federal courts, then, no federal court has ever decided a federal question. Congress has said that royalties, like rents, are ordinary income. The Court of Appeals in this case, by affirming the *Gray* case, has said that royalties are not income, but a cash consideration for the partial alienation of property. Based upon the declaration that royalties are not ordinary income, but a cash consideration for the partial alienation of property, the court held that the royalties belonged to the separate estate of the husband and did not fall into the community, like rent and other income to be returned as community income. *Poe vs. Seaborn*, 282 U.S. 101. It is true that the court did examine the Louisiana law to see to whom, under local law, these royalties belonged, but it is equally true that the court held they belonged to the husband and not to the community, because they were not ordinary income, but the sale of an asset. This conclusion is inevitable and contradictory of the decisions of this Court and other decisions on the subject.

It passes understanding, therefore, how it can be contended that the decision was based upon, and dealt only, with local law. At the foundation of the decision,

lies the repudiation of the declaration of Congress that royalties are ordinary income. If the court had held that these royalties were ordinary income, under Louisiana law, it would have been bound to hold that this was income belonging to the community. *Succession of Weber*, 49 La. Ann. 1494; *Barbin vs. Couvillon*, 122 La. 407; *Succession of Goll*, 156 La. 910; *Peters vs. Klein*, 161 La. 664.

Based upon the denial that royalties are ordinary income, the Court of Appeals upheld the Commissioner by holding that royalties are the price for the partial alienation of land. We can readily agree with that part of the brief in opposition which says:

> "While the federal taxing statute, in some instances, looks to local law to determine the owner of the income to whom it is to be taxed (*Poe v. Seaborn*, 282 U.S. 101; *Bender v. Pfaff*, 282 U.S. 127), the character of the income as being capital gain or ordinary income is a matter to be resolved solely under the criteria of the federal taxing statute which was intended to have a uniform application throughout the country (*Burnet v. Harmel, supra;* cf. *Palmer v. Bender*, 287 U.S. 551)".

There can be no doubt that this is a clear statement of the controlling principles, but, equally, there can be no doubt that the decision of the Court of Appeal is contrary to the stated principle.

We can partly agree and partly disagree with the statement of the brief in opposition to the following effect:

> "Similarly, the fact that oil royalties are taxed as ordinary income under the federal statute cannot, contrary to the taxpayer's underlying assumptions (Pet. 4-10; Br. 4-22), require

> the State of Louisiana to regard them in a similar manner so as to make them fall into the community, nor change the law of that State which views them as proceeds from the sale of property and as belonging to the spouse from whose property they are derived".

There can be no doubt that the taxing statutes of the United States cannot condition the marital relations of Louisiana citizens. However, the court was not dealing with those marital relations, but was dealing with the taxing statutes of the United States, and those taxing statutes are to be viewed in accordance with federal jurisprudence. Federal jurisprudence declares that royalties are income and under the cited case of *Bender vs. Pfaff, supra,* coming up from Louisiana, this court held that the income of the husband and wife could be returned as community income. Since Congress has declared royalties to be income, and not the consideration from the sale of property, it must follow that it is income for every purpose of the taxing statutes. The statement that the law of Louisiana does not regard royalties as income, like rents, but as the cash consideration for the sale of property, finds no support in the law of Louisiana.

In *Spence v. Lucas,* 138 La. 763, the court said:

> "Interveners are not asking for more than the recognition of their lease. They are not claiming that the oil and gas under the surface of the soil was sold to them. They adopt the expression of opinion by the court in the cases of *Cooke v. Gulf Refining Co.*, 127 La. 592, 53 South. 874, *Rives v. Gulf Refining* Co., 133 La. 178, 62 South. 623, and *Cooke v. Gulf Refining Co.*, 135 La. 609, 65 South. 758, to the effect that mineral leases will be construed as leases, and not sales, and that the law with reference to leases will be applied thereto in so far as they may be".

In *Board of Commissioners of Caddo Levee District v. Pure Oil Company*, 167 La. 801, 811, the court said:

> "The next question to be considered is whether the prescription pleaded, which is a prescription relating to arrearages of rent, is applicable to this case. In the case of *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526, which involved a mineral lease, as does the present case, this court said:
>
> > " 'Our conclusion is that a mine or quarry, or land adapted to mining or quarrying, may be leased for a certain portion of the produce of such mine or quarry, and the fact that said portion is called 'royalty' instead of rent, is not of the least consequence. For rent (by whatever name called) is a certain profit in money, provisions, chattels, or labor, issuing out of lands and tenements in retribution for the use' ". (Citing) *King v. Harper*, 33 La. Ann. 496, citing Bouv. Law Dict. verbo, 'Rent' ".
>
> "In that case, the court recognized a lessor's privilege for the unpaid royalty or rent, thus giving the lease the effect of an ordinary lease. It is true that the royalty or rent charge involved in that case was an amount in money, based on the quantity of gravel removed from the land, whereas in this case the royalty or rent charge under the lease is one-eighth of the oil produced. That difference, however, is of no consequence, nor is the ruling in the case cited based on any such distinction. The rent charge 'may consist in a certain quantity of commodities, or even in a portion of the fruits yielded by the thing leased'. C.C. art. 2671".

In *Roberson v. Pioneer Gas Co.*, 173 La. 313, 319, the court said:

> "in oil and gas leases, under the settled jurispru-

dence of this state, the payment of a royalty is the payment of rent, and is not the payment of a price for the oil or gas rights, as if they were sold. See *Spence v. Lucas*, 138 La. 763, 70 So. 796; *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 373".

In *Shell Petroleum Corp. v. Calcasieu Real Estate & O. Co.*, 185 La. 751, 771, the Court said:

> "It is well settled that the paying of a royalty, under a mineral lease, is the paying of rent. *Spence v. Lucas*, 138 La. 763, 70 So. 796: *Logan v. State Gravel Co.*, 158 La. 105, 103 So. 526; *Board of Commissioners of Caddo Levee District v. Pure Oil Co.*, 167 La. 801, 120 So. 272; *Roberson v. Pioneer Gas Co.*, 173 La. 313, 137 So. 46, 82 A. L. R. 1264."

In *Gulf Refining Company vs. Glassell*, 186 La. 190, the court said:

> "On several occasions this court has decided that the usual oil and gas lease with a cash or royalty consideration, or both, such as presently before us, is a contract of letting and hiring within the meaning of the codal articles, and therefore does not create a servitude on the realty or a real right in the land. *Cooke v. Gulf Refining Co.*, 127 La. 592, 53 So. 874; *Rives v. Gulf Refining Co.*, 133 La. 178, 62 So. 623; *Cooke v. Gulf Refining Co.*, 135 La. 609, 65 So. 758; *Gulf Refining Co. v. Hayne*, 138 La. 555, 70 So. 509, L.R.A. 1916 D. 1147, Ann. Cas. 1917D, 130; *Spence v. Lucas*, 138 La. 763, 70 So. 796; Hennen's Digest, vol 1, 479, 480; *Allen v. Shreveport Mutual Bldg. Ass'n*, 183 La. 521, 625, 164 So. 328; and articles 2669, 2670, 2671, 2674, 2670 of the Revised Civil Code".

* * * * *

"Now it is said that a lease upon land for the drilling for oil and gas, fugitive minerals, is so basically different from a lease on realty for raising crops that the two kinds of leases should not be legally treated the same. Are they so different? They are granted by the owner in connection with his land for a consideration consisting of cash or part of the production therefrom, or both. The oil and gas lessee gets the products from under the surface of the ground and the lessee of a farm or plantation harvests the crops from the surface of the earth. They both get title to the products. Neither claims ownership of the land, and each is entitled to the use and enjoyment of the property for the purposes for which it was leased. In fact, it is easier to see greater similarity between an oil and gas lease and the lease of a farm than the lease of a building and a farm lease. Yet the latter are classified the same. It therefore appears to us that an oil and gas lease and farm lease are quite alike and should be placed in the same legal catefory, i. e., leases—personal rights and not real rights."

" * * * *Roberson v. Pioneer Gas Co.*, 173 La., 313, 137 So. 46, 82 A. L. R. 1264, held, as stated in the syllabus:

> " 'In oil and gas lease, payment of royalty is payment of rent, and not payment of price for oil or gas rights.
>
> " 'Lease, under civil law, does not convey to lessee temporarily title to property leased, but conveys only right to use or enjoyment of property. (Rev. Civ. Code, arts. 2669, 2674.)'

Tyson v. Surf Oil Co., 195 La. 248, 196 So. 336, 342.

"This court has also firmly established the rule that mineral leases would be construed as leases and the codal provisions applicable to or-

dinary lease would be applied thereto insofar as they may be."

Robinson v. Horton, et al., 197 La. 919, 2 So. (2d) 647, 649.

> " 'Under the jurisprudence of this State "It is well settled that the payment of royalty, under a mineral lease, is the payment of rent" ' ".

Coyle v. North American Oil Consolidated, et al., 201 La. 99, 9 So. (2d) 473, 478.

> " 'The rule is well established that mineral leases *must* be construed as leases, and that the codal provisions applicable to ordinary lease *must* be applied. *Tyson v. Surf Oil Co.* 195 La. 248, 196 So. 336' ".

The statement that the law of Louisiana views royalties "as proceeds from the sale of property and as belonging to the spouse from whose property they are derived", is clearly refuted by the cited cases. The citation of *Turbeville vs. Commissioner*, 84 Fed. (2d) 302, is wholly inapplicable to the decision of this case. The *Turbeville* case came up from Texas, where oil in place is regarded as a part of the realty and, consequently, a royalty contract was, under Texas law, regarded as the sale of real estate. Under the law of Louisiana, oil in place is not regarded as a part of the realty. The Louisiana court, in the often cited case of *Frost-Johnson Lumber Company v. Salling's Heirs*, 150 La. 756, held that oil in place was not a part of the realty. It adopted the fugacious theory of oil and gas and held that the surface owner did not own the oil and gas, but had merely the right of use of the land to explore for oil and gas, and when reduced to possession, to become the owner of such oil and gas. The holding of the Court of Appeals

that this was a dismemberment of the property and not a consideration for its use, is wholly at variance with the jurisprudence of Louisiana.

CONCLUSION

We respectfully say that the decision holding that royalties are the receipt of a consideration for the alienation of land is at variance with the decisions of this court and the decisions of other Courts of Appeal, and even with decisions in the 5th Circuit Court of Appeals, and unless that decision is set aside, Warren J. Harang will claim the right to return these royalties as a capital gain. Doubtless this will be resisted by the Commissioner and the case will come before this court again, because, certainly, royalties, insofar as Warren J. Harang is concerned, cannot be a capital gain in one year and ordinary income in another year. The question of the marital status of Warran J. Harang is no consideration for decision here. It would be an anomaly in the taxing laws of this country if it could be held that royalties, insofar as a married man is concerned, are not ordinary income, but as to a single man, they are ordinary income. The nature of royalties as ordinary income or capital gain cannot vary with the marital status of the landowner. The fall of the income as to whether within or without the community, cannot affect the nature of royalties. The difference in marital status cannot condition the category into which these royalties fall. Your Honors must pronounce as to whether royalties received in Louisiana are the cash consideration for the partial alienation of land, but in other states are ordinary income as proclaimed by Congress. Their nature is not varied by state lines.

The writ of certiorari should, therefore, be granted

upon the twin considerations that the Court of Appeals has failed to apply both the taxing statutes of Congress and the laws of Louisiana regarding the ownership of income.

Respectfully submitted,

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